Internal Revenue Service

Number: **200243001**
Release Date: 10/25/2002
Index Number: 1042.00-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EB:QP2 PLR-146427-01
Date:
June 5, 2002

LEGEND

Taxpayer A =

Taxpayer B =

Taxpayer C =

Company =

ESOP =

Partnership =

Date L =

Date M =

State X =

Dear :

This responds to your letter requesting a ruling on behalf of the above-named taxpayer on the application of section 1042 to certain transactions described below.

According to the facts submitted and the representations made, the Company is a domestic C corporation and has no stock outstanding that is readily tradable on an established securities market. The Company maintains the ESOP which qualifies under section 401(a) and meets the requirements of section 4975(e)(7) of the Code.

Prior to Date L, Taxpayers A and B owned stock in the Company. None of this stock was acquired in a distribution from a plan described in section 401(a) or in a transfer pursuant to an option or other right to acquire stock to which section 83, 422 or 423 applied (or to which section 422 or 424 (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) applied). On Date L, Taxpayers A and B had each owned their shares for more than three years. Taxpayers A and B are husband and wife; Taxpayer C is their son.

On Date L, Taxpayers A and B contributed shares of Company common stock to Partnership in exchange for limited partner interests totaling 99% of the partnership. The remaining 1% general partner interest is held by an S corporation controlled by Taxpayer A.

On Date M, Partnership sold shares of Company common stock to the ESOP. On the same date and as part of the same integrated transaction, the ESOP purchased an additional shares of Company common stock from other shareholders. After these purchases, the ESOP owned % of Company's issued and outstanding common stock.

Partnership filed the written statement required by section 1042(b)(3) with its federal income tax return for the year of the sale, and has filed a statement of election under section 1042(a) for the sale of Company stock to the ESOP. Partnership has, within the replacement period (as defined in section 1042(c)(3)), purchased securities which, for purposes of this ruling request, are presumed to be qualified replacement property within the meaning of section 1042(c)(4). No ruling was requested and none is given concerning whether Partnership satisfied the requirements for an election under section 1042(a) and section 1.1042-1T of the Temporary Income Tax Regulations with respect to the sale of Company stock to the ESOP.

Taxpayer A proposes that the following actions be taken: Partnership will be converted into a limited liability company ("LLC") pursuant to the law of State X. After the conversion, LLC will be classified as a partnership for federal tax purposes pursuant to section 301.7701-3(b)(1)(i) of the regulations. At all times relevant to the ruling, neither Partnership nor LLC will have any liabilities, and no interest in Partnership or LLC will be subject to any liabilities. LLC plans to sell additional shares of Company common stock to the ESOP from time to time.

The Taxpayers request the following rulings:

1) The Company stock contributed to Partnership by Taxpayers A and B, and sold to the ESOP by Partnership, will have its holding period, for purposes of the holding period requirement of section 1042(b)(4), determined by the date on which Taxpayers A and B, respectively, acquired the Company stock.

2) Partnership is the proper taxpayer to elect to defer gain under section 1042 for Company stock sold to the ESOP on Date M.

3) A gift transfer by Taxpayer A or B of a limited partnership interest in Partnership is not a disposition of qualified replacement property owned by Partnership for purposes of section 1042(e).

4) The conversion of Partnership into an LLC is not a disposition of qualified replacement property owned by Partnership for purposes of section 1042(e).

5) The Company stock owned by LLC following such conversion and contributed to Partnership by Taxpayers A and B will have its holding period, for purposes of the holding period requirement of section 1042(b)(4), determined by the date on which Taxpayers A and B, respectively, acquired the Company stock.

6) With respect to sales of Company stock owned by LLC after the conversion, the LLC is the proper taxpayer to elect to defer gain under section 1042 for Company stock sold by the LLC to the ESOP.

7) A gift transfer by Taxpayer A or B of an interest in the LLC is not a disposition of qualified replacement property owned by LLC for purposes of section 1042(e).

Section 1042(a) of the Internal Revenue Code provides that a taxpayer or executor may elect in certain cases not to recognize long-term capital gain on the sale of "qualified securities" to an ESOP (as defined in section 4975(e)(7)) or eligible worker owned cooperative if the taxpayer purchases "qualified replacement property" (as defined in section 1042(c)(4)) within the replacement period of section 1042(c)(3) and the requirements of section 1042(b) and section 1.1042-1T of the Temporary Income Tax Regulations are satisfied.

For taxable years beginning after December 31, 1997, section 1042(c)(1) provides that the term "qualified securities" means employer securities (as defined in section 409(l)) which are issued by a domestic C corporation that has no stock outstanding that is readily tradable on an established securities market; and were not received by the taxpayer in a distribution from a plan described in section 401(a), or in a transfer pursuant to an option or other right to acquire stock to which section 83, 422 or 423 applied.

The taxpayer must purchase "qualified replacement property" (QRP) within the "replacement period" which is defined in section 1042(c)(3) as the period which begins 3 months before the date on which the sale of qualified securities occurs and ends 12 months after the date of such sale.

Issues 1 and 5

In order to qualify for nonrecognition under section 1042(a), section 1042(b)(4) requires that the taxpayer's holding period with respect to the qualified securities be at least 3 years (determined as of the time of sale).

Section 1223(2) provides that in determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution, increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

Accordingly, with respect to ruling request one, by application of sections 723 and 1223(b), and assuming that section 721(b) is inapplicable, Partnership's holding period, for purposes of section 1042(b)(4), in the Company common stock contributed by Taxpayers A and B will include the periods during which it was held by Taxpayer A and B, respectively.

We further conclude with respect to ruling request five that, by application of sections 723 and 1223(b), for purposes of section 1042(b)(4), LLC's holding period in the Company common stock will include the periods during which it was held by Taxpayers A and B, and Partnership.

Issue 2

Section 703(b) provides that any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under: (1) section 108(b)(5) or section 108(c)(3) (relating to income from discharge of indebtedness); (2) section 617 (relating to deduction and recapture of certain mining exploration expenditures; or (3) section 901 (relating to taxes of foreign countries and possessions of the United States) shall be made by each partner separately. Section 1042 is not one of the listed statutory exceptions to the general rule that the partnership, rather than its partners, must make any election that affects the computation of partnership income.

In the present case, Partnership sold Company common stock to the ESOP. The election under section 1042 to defer recognition of long term capital gain from the sale of the stock affects the computation of Partnership's taxable income. Therefore, pursuant to section 703(b), Partnership is the proper party to make the election. After

Partnership is converted to LLC, LLC also will sell Company common stock to the ESOP. Since LLC will be treated as a partnership for federal tax purposes, the partnership rules regarding elections will apply to LLC. Accordingly, with respect to ruling requests 2 and 6, we conclude that, pursuant to section 703(b) an election to defer gain under section 1042 with respect to a sale of employer securities by Partnership to the ESOP must be made by Partnership and not its partners. Likewise, any election to defer gain under section 1042 with respect to a sale of employer securities by LLC to the ESOP must be made by LLC, and not its members.

Issues 3 and 7

Section 1042(e)(1) of the Code provides that "if a taxpayer disposes of any qualified replacement property, then, notwithstanding any other provision of this title, gain (if any) shall be recognized to the extent of the gain which was not recognized under subsection (a) by reason of the acquisition by such taxpayer of such qualified replacement property."

The legislative history of section 1042(e) indicates that it was added as part of the Tax Reform Act of 1986 to coordinate the requirement that deferred gain be recognized on the disposition of any QRP with other nonrecognition provisions of the Code. "Effective for dispositions made after the date of enactment, the Act overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time." S. Rep. 99-313, 99th Cong., 2nd Sess., 1032 (1986), 1986-3 C.B., v. 3, 1032. Limited exceptions to this rule are provided in section 1042(e)(3). Thus, gain realized from the disposition of any QRP by a taxpayer who made an election under section 1042 must be recognized at the time of the disposition regardless of any other nonrecognition provisions of the Code that may otherwise have applied.

Section 1042(e)(3) provides that the recapture rules of section 1042(e)(1) shall not apply to any transfer of qualified replacement property that occurs: 1) in any reorganization (within the meaning of section 368) unless the person making the election under section 1042(a)(1) owns stock representing control of the acquiring or acquired corporation and such property is substituted basis property in the hands of the transferee; 2) by reason of the death of the person making the election; 3) by gift, or 4) in any transaction to which section 1042(a) applies. Neither the statute nor the Temporary Income Tax Regulations define the term "gift" for purposes of section 1042(e)(3).

For purposes of section 1042(e), Taxpayer A or B’s transfer by gift of a limited partnership interest in Partnership or of an interest in LLC will not cause a recognition of gain under section 1042(e).

Issue 4

Section 708(a) provides that a partnership is considered as continuing if it is not terminated. Under section 708(b) a partnership is considered terminated only if (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners or (2) within a 12 month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Section 1.708-1(b)(2) of the Income Tax Regulations provides that a contribution of property to a partnership does not constitute a sale or exchange for purposes of section 708.

Revenue Ruling 84-52, 1984-1 C.B. 157, considers the federal income tax consequences of the conversion of a general partnership into a limited partnership. Each partner's total percent interest in the partnership's profit, losses, and capital remains the same after the conversion. Further, the business of the general partnership continues to be carried on after the conversion.

Revenue Ruling 84-52 holds that the general partnership is not terminated because the business of the general partnership will continue after the conversion and because under section 1.708-1(b)(2) of the regulations, the transaction is not treated as a sale or exchange for purposes of section 708.

Revenue Ruling 95-37, 1995-1 C.B. 130, examines the conversion of a domestic partnership into a domestic LLC classified as a partnership for federal tax purposes. Rev. Rul. 95-37 holds, in part, that the federal income tax consequences described in Rev. Rul. 84-52 apply to the conversion of a domestic partnership into a domestic LLC classified as a partnership regardless of the manner in which the conversion is achieved under state law.

In the present case, Partnership will continue to carry on business after the conversion, the partners will hold interests in the capital, profits, and losses of the LLC in the same proportion that they held such interests in Partnership, and there will be no change in the partners' shares of the partnership's liabilities. Therefore, provided that Partnership and LLC are correctly classified as partnerships for federal tax purposes, we conclude that the conversion of Partnership into LLC will not result in a termination of Partnership under section 708, and, for federal tax purposes, LLC will be considered a continuation of Partnership.

Because LLC will be considered a continuation of Partnership and LLC will continue to hold the qualified replacement property, we conclude that Partnership will not have disposed of the qualified replacement property under section 1042(e).

Therefore, based on the specific facts of this case and representations made by the taxpayers, we conclude as follows:

1) By application of sections 723 and 1223(b), and assuming that section 721(b) is inapplicable, Partnership's holding period, for purposes of section 1042(b)(4), in the Company common stock contributed by Taxpayers A and B will include the periods during which it was held by Taxpayers A and B, respectively.

2) Partnership is the proper taxpayer to elect to defer gain under section 1042 for Company stock sold to the ESOP on Date M.

3) Taxpayer A or B's transfer by gift of a limited partnership interest in Partnership will not cause a recognition of gain under section 1042(e).

4) Because LLC will be considered a continuation of Partnership and LLC will continue to hold the qualified replacement property, we conclude that Partnership will not have disposed of the qualified replacement property under section 1042(e) upon the conversion of Partnership into LLC.

5) By application of sections 723 and 1223(b), for purposes of section 1042(b)(4), LLC's holding period in the Company common stock will include the periods during which it was held by Taxpayers A and B, and Partnership.

6) With respect to sales of Company stock owned by LLC after the conversion, the LLC is the proper taxpayer to elect to defer gain under section 1042 for Company stock sold by the LLC to the ESOP.

7) Taxpayer A or B's transfer by gift of an interest in LLC will not cause a recognition of gain under section 1042(e).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under section 721(b) or any other provision of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayers.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. Since this office has not verified any of

the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely yours,

Robert D. Patchell
Chief, Qualified Plans Branch 2
Office of Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosures:
Copy of this letter
Copy for 6110 purposes